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No. 93

In The

Supreme Court of the United States

October Term, 1993

TOM MISTICK & SONS, INC.,

Petitioner,

v.

COMMONWEALTH OF PENNSYLVANIA,

Respondent.

Petition For A Writ Of Certiorari To The Supreme Court Of Pennsylvania

PETITION FOR A WRIT OF CERTIORARI

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52 pp

QUESTION PRESENTED

Whether Pennsylvania's refusal to permit federal S corporations a deduction for federal income taxes in fixing the valuation of capital stock, while allowing such a deduction for C corporations (where there is no significant difference between the two classes of corporations), represents a violation of equal protection.

PARTIES TO THIS PROCEEDING AND RULE 29.1 STATEMENT

The decision of the Supreme Court of Pennsylvania, reprinted in Appendix A to this Petition, lists all parties to the proceeding in the state Supreme Court in the caption of that decision.

The present Petitioner is Tom Mistick & Sons, Inc., a privately held corporation with no parent corporation and no subsidiaries.

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PETITION FOR A WRIT OF CERTIORARI

Tom Mistick & Sons, Inc. respectfully petitions for a writ of certiorari to review the judgment of the Supreme Court of Pennsylvania in this case.

OPINIONS BELOW

The Opinion of the Pennsylvania Supreme Court (App. A, *infra*) is officially reported at 637 A.2d 607 (Pa. 1993). The Order of the Pennsylvania Supreme Court denying reargument (App. C, *infra*) is unreported. The Opinion of the Commonwealth Court of Pennsylvania (App. B, *infra*) is officially reported at 149 Pa. Commw. 389, 613 A.2d 143 (1992). The Order of the Commonwealth Court of Pennsylvania dismissing exceptions (App. D, *infra*) is unreported.

JURISDICTION

The judgment of the Supreme Court of Pennsylvania was entered on February 7, 1994 (App. A, at p. 18). The Supreme Court of Pennsylvania denied reargument on March 21, 1994 (App. C, at p. 1). The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL STATUTORY AND REGULATORY PROVISIONS INVOLVED

The constitutional, statutory and regulatory provisions involved are set forth at App. E.

STATEMENT

A. Facts

On August 29, 1991, Tom Mistick & Sons, Inc. ("Mistick") agreed with the Commonwealth of Pennsylvania ("Pennsylvania") on a stipulation of facts which was filed with the Commonwealth Court. These stipulations constituted the record both in the Commonwealth Court proceeding and on appeal to the Supreme Court of Pennsylvania. (R.R. pp. 13a-123a.)[1] The following is a brief summary of these undisputed facts.

Both Pennsylvania and the federal government have enacted provisions that allow tax on income for qualifying small corporations, known as S corporations, to be reported on the returns of the individual shareholders, rather than by the corporation. See 26 U.S.C. § 1361 *et seq.*; 72 P.S. §§ 7307-7309.[2] During the years in question, Mistick was an S corporation for federal income tax purposes. (Stipulation, 5A; R.R. p. 48a.) For purposes of this case, the only difference between a federal S corporation and a C corporation is the manner in which federal taxes are reported and paid. The tax consequences of a federal S corporation election are specifically limited by the applicable statute to federal taxes on corporate income.

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[1] Citations to the record on appeal in the Supreme Court of Pennsylvania are designated R.R. followed by the page reference.

[2] Corporations that do not make this election are commonly referred to as C corporations.

26 U.S.C. § 1363(a). Federal S corporations, therefore, are treated the same as C corporations by the Commonwealth with respect to the imposition of a property tax on the value of their capital stock. (Stipulation, ¶ 18; R.R. p. 52a.) However, they are treated differently when it comes to fixing the value of that stock.

Effective for tax years beginning in 1984, Pennsylvania enacted a fixed formula statute for calculating capital stock value. The tax years in question were subject to this newly enacted statutory fixed formula. (Stipulation, ¶¶ 19 and 20; R.R. p. 52a.) For the 1984 and 1985 tax years in question, Mistick, in the course of determining its capital stock tax value, took a deduction for federal income taxes when calculating income per books. (Stipulation, ¶ 6; R.R. p. 48a.) This had been the custom and practice of Mistick and other federal S corporations for years prior to enactment of the fixed formula amendment, and for pre-fixed formula years the Pennsylvania Department of Revenue allowed such a deduction for both S corporations and C corporations. (Stipulation, ¶ 16; R.R. p. 50a.) Thus, for purposes of fixing the value of their capital stock, all corporations were treated alike prior to the enactment of the fixed formula statute.

Following the 1984 amendment, the Department of Revenue took the position that the statutory amendment, which established the fixed formula for calculation of capital stock tax value, prohibits a deduction of federal taxes by S corporations. (Stipulation, ¶ 16; R.R. p. 50a.) Consequently, the Department of Revenue settled Mistick's capital stock tax reports for the years in question, denying the deduction taken for federal taxes in the

course of calculating income per books, thereby increasing Mistick's capital stock tax as reported. (Stipulation, ¶¶ 7, 8 and 9; R.R. pp. 48a, 49a.)[3] C corporations, however, were and continue to be permitted to deduct federal taxes when calculating income per books. This is so even though some C corporations, who file their returns as part of a consolidated return and thus benefit from losses of other members of their consolidated group, do not pay any federal tax on that income. (Stipulation, ¶ 17; R.R. p. 51a.)

B. Calculation of Capital Stock Tax

Pennsylvania imposes a tax measured by and imposed on the capital stock value of domestic corporations; that is, on companies incorporated under the laws of Pennsylvania. 72 Pa. C.S.A. § 7602(a).[4] The corporation at issue here is a domestic corporation and therefore subject to Capital Stock tax.

1. Statute and Interpretation – Pre-Fixed Formula

Prior to 1984, the Pennsylvania Capital Stock Tax was imposed on an appraised value of the taxpayer's capital

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[3] All Pennsylvania Capital Stock Tax reports are subject to audit and approval. That process and any resulting change in the report is referred to as a settlement of the tax. 72 Pa. C.S.A. § 7407(a).

[4] Foreign corporations doing business in Pennsylvania are subject to the Franchise Tax. 72 Pa. C.S.A. § 7602(b). The tax rate and tax base are the same and foreign corporations electing federal S corporation treatment are also denied the deduction for federal taxes.

stock. The statute spelled out four basic elements to be considered in ascertaining the appraised value of the taxpayer's capital stock, one of which was earnings or profits of the Corporation.[5] Tax Reform Code § 601 prior to amendment by the Act of December 22, 1983, No. 89, § 1 (P.L. 360) (the "Act"). However, the pre-fixed formula statute did not include a mathematical formula for calculating the capital stock value based on these four elements.

Department of Revenue Regulations generally defined the corporate earnings element as book income. 61 Pa. Code § 155.22 ("corporate earnings"). The term "book income" was further defined by Regulation as:

> Income as reported in Line 1 of Schedule M-1 of the Federal 1120 Form.

61 Pa. Code § 155.22 (Book Income). This line on the 1120 form is titled "net income per books."

Based on the foregoing, the Department of Revenue consistently interpreted the term book income or net income per books to permit a deduction by S corporations for federal taxes and routinely allowed S corporations to make this deduction when calculating net income per book for capital stock tax purposes. (Stipulation, ¶ 16; R.R. p. 48a.)[6]

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[5] The other elements were the average selling price of stock, dividends declared and stockholder equity. *See* 61 Pa. Code § 155.22.

[6] For the years in question and for years prior to the fixed formula amendment, the federal S corporation return did not contain a Schedule M-1 or any line titled income per books.

2. Statute and Interpretation – Fixed Formula

For taxable years beginning in 1984, the method for calculating capital stock tax value was statutorily defined. Capital stock value was expressed as:

> The amount computed pursuant to the following formula: the product of one-half times the sum of the average net income capitalized at the rate of nine and one-half percent plus seventy-five percent of net worth, from which product shall be subtracted fifty thousand dollars ($50,000). . . .

72 Pa. C.S.A. § 7601(a) ("capital stock value").

The amended statute eliminates two of the pre-fixed formula elements from consideration, and provides for calculation of capital stock tax value based on only two remaining components, average net income and net worth. The statute defines average net income and provides in pertinent part:

> The net income or loss of the entity for any taxable year shall be the amount set forth as *income per books* on the income tax return filed by the entity with the Federal government for such taxable year, or if no such return is made, as would have been set forth had such a return been made. . . .

72 Pa. C.S.A. § 7601(a) ("Average Net Income") (emphasis added). It is undisputed that the term "income per

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Schedule M-1 first appeared on the S corporation return Form 1120S in 1990. (Stipulation, ¶ 15; R.R. p. 50a; App. A, p. 11; App. B, p. 6.)

books," which is the term used in the amendment, refers to "net income per books," which was the pre-fixed formula measure of earnings. (App. B, p. 6; R.R. p. 173b.)

When the fixed formula amendment was enacted, the Department of Revenue adopted a policy that, for those tax years subject to the fixed formula, federal S corporations would no longer be entitled to a deduction for federal taxes in the course of calculating income per books for capital stock tax purposes. In order to carry out this policy, the Department of Revenue promulgated the regulation fully set forth in Appendix E, at p. 2. 61 Pa. Code § 155.26(g).

C. Decisions Below

Mistick brought suit challenging the settlement on the ground that the Department of Revenue regulation denying a federal tax deduction to federal S corporations was not authorized by the fixed formula amendment, since the amending language was virtually identical to that used in the prior act.[7] In the alternative, Mistick argued that if in fact the statutory amendment contemplated this change in treatment of federal S corporations, then it violated the United States Constitution, including the equal protection clause. It also argued that it therefore represented a violation of Mistick's civil rights.[8]

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[7] Tool Sales & Service Co. ("Tool Sales") also brought suit to challenge its capital stock settlement. The cases were consolidated for argument before Commonwealth Court and on appeal to the Supreme Court of Pennsylvania. Only Mistick sought reargument before the Supreme Court of Pennsylvania, and only Mistick seeks a writ of certiorari.

[8] This Court has held that discriminatory taxing schemes represent a violation of civil rights and form a basis for an

The Commonwealth Court of Pennsylvania determined, sua sponte, that the legislature had intended that income per books be determined by reference to Internal Revenue Regulation (IRR) 1.56-1, 26 C.F.R. 1.56-1 (1991) (App. B, at pp. 7, 8), and that the Department of Revenue regulation was authorized by the statutory amendment. (App. B, at p. 8.) The Court further dismissed the claim of unequal treatment, and ruled that there was, therefore, no basis for an award of attorneys' fees. (App. B, at p. 8.)

Mistick appealed the decision of the Commonwealth Court. The Supreme Court of Pennsylvania, while refusing to follow the rationale of the Commonwealth Court, nonetheless affirmed that decision, holding that the regulation was a reasonable interpretation of legislative intent. (App. A, at p. 14.) The Supreme Court further found that Mistick had not met its burden of establishing that the distinction between federal S corporations and C corporations was not a rational basis for different treatment. (App. A, at p. 17.) Since the Supreme Court found no violation of equal protection, there was no basis for an award of attorneys' fees. (App. A, at pp. 17, 18.)

REASONS FOR GRANTING THE PETITION

The Pennsylvania Supreme Court's decision has an important and adverse impact on the taxation of any federal S corporation. This impacts both domestic corporations and those incorporated outside Pennsylvania but

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award of attorneys' fees. 42 U.S.C. §§ 1983, 1988; *Dennis v. Higgins*, 498 U.S. 439, 112 L.Ed.2d 969, 111 S. Ct. 865 (1991).

doing business in Pennsylvania. In substance, the Supreme Court has held that federal S corporations are to be taxed on a higher property tax value than C corporations, even though some C corporations are identically situated with the S corporations. It is undisputed that this scheme is the intentional result of the Pennsylvania Department of Revenue policy. (Stipulation, ¶¶ 16, 17; R.R. pp. 50a, 51a.) Such intentional, systematic and invidious discrimination in the valuation of property presents an important question touching the accommodation of state and federal interests under the United States Constitution. This has been found to be sufficient basis for the grant of certiorari. *Kosydar v. National Cash Register Co.*, 417 U.S. 62, 40 L.Ed.2d 660, 94 S. Ct. 2108 (1974).

The decision of the Pennsylvania Supreme Court also conflicts with prior decisions of this Court finding such methodical discrimination in valuation of property to be a violation of equal protection. *Allegheny Pittsburgh Coal Company v. County Commission of Webster County*, 488 U.S. 336, 102 L.Ed.2d 688, 109 S. Ct. 633 (1989); *Cumberland Coal Co. v. Board of Revision of Tax Assessments in Green County, Pa.*, 284 U.S. 23, 76 L.Ed. 146, 52 S. Ct. 48 (1931).

A. The Discriminatory Treatment

The Pennsylvania capital stock tax is not a tax measured by income but is a direct property tax on the value of the capital stock of a corporation. *Central Railroad Company of Pennsylvania v. Commonwealth*, 370 U.S. 607, 8 L.Ed.2d 720, 82 S. Ct. 1297 (1962); (App. A, at p. 5). Prior to enactment of the fixed formula amendment in 1984, all

corporations, including S corporations, calculated capital stock tax on the same tax base and at the same rate.[9]

One component of that tax base was corporate earnings or "net income per books." 61 Pa. Code § 155.22. Prior to the fixed formula amendment, both S corporations and C corporations calculated net income per books in the same manner. (Stipulation, ¶ 16; R.R. p. 50a.) Despite the fact that the Department of Revenue conceded that the undefined term "income per books" appearing in the amendment was the equivalent of the term "net income per books" (the pre-fixed formula measure of earnings used in the statute before its amendment), the Pennsylvania Supreme Court has upheld the Department of Revenue's change in the interpretation of that term as it applies to federal S corporations. For post-fixed formula years, federal S corporations are prohibited from deducting a federal tax provision when calculating income per books. 61 Pa. Code § 155.26(g). The result is that all federal S corporations which are subject to the Capital Stock/Franchise Tax in Pennsylvania are now taxed on a property tax base greater than that of C corporations.

The Pennsylvania Supreme Court further found the distinction between S corporations and C corporations to be a legitimate one, since the owners voluntarily elect S

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[9] Federal Subchapter S provisions were first enacted as part of the Technical Amendments Act of 1958. P.L. 85-866, § 64, 85th Cong., 2d. Sess. (1958), former 26 U.S.C. §§ 1371 through 1377. Pennsylvania capital stock tax has been imposed on corporations since 1840. See former 72 P.S. §§ 1871, 1891, 1892, 1901, 1902.

corporation status and as a consequence the corporation does not pay federal tax. (App. A, at p. 16.)[10] On the basis of these distinctions, the Court determined that there was no violation of equal protection. (App. A, at p. 17.)

Assuming, arguendo, that these distinctions would generally form a rational basis for taxing federal S corporations and C corporations differently, the Court, nonetheless, has utterly failed to justify a more favorable treatment of certain C corporations which are identically situated to S corporations. For example, certain "includable corporations" that are connected through stock ownership with a common parent may voluntarily elect to file a consolidated income tax return with the federal government. 26 U.S.C. §§ 1501, 1504.[11] An election to file a consolidated federal return has the effect of converting the group into a single tax computing unit. Thus, the incomes and losses of all corporations are consolidated on a single return and the federal tax due, if any, is computed on the consolidated net income (loss).

The Pennsylvania Capital Stock Tax provisions require that all corporations calculate income per books on an unconsolidated basis. 72 Pa. C.S.A. § 7601(a). As a result, a C corporation, which participates in the filing of

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[10] The Court reaches this conclusion despite the clear and unambiguous mandate in the federal statute that the tax consequence of the election is limited to taxes imposed under the RIC. 26 U.S.C. § 1363(a).

[11] Although 26 U.S.C. § 1504(b) does not exclude subchapter S corporations from the definition of an includable corporation, 26 U.S.C. § 1361(b)(2)(A) prevents S corporations from being members of an affiliated group. Thus, S corporations cannot participate in consolidated filings.

a consolidated return, may generate a separate federal return indicating a profit even though the consolidated federal return reported a loss. It is the Department of Revenue's policy to allow this C corporation a deduction for federal income taxes when computing income per books even though the corporation, due to losses incurred by other members of the group, does not pay federal tax on this income. (Stipulation, ¶ 17; R.R. p. 51a.)

Both federal S corporations and the aforementioned C corporations have made voluntary elections with the federal government, the result of which is that neither corporation has paid federal tax on its income. Based on the rationale of the Pennsylvania Supreme Court, these corporations should receive uniform treatment. Yet, a C corporation is permitted to reduce its tax base by the "hypothetical" federal tax while an S corporation is denied the "hypothetical" federal tax deduction and is taxed on a higher tax base. 61 Pa. Code § 155.26(g).

Part of the rationale for the Pennsylvania Supreme Court's decision was that S corporations were attempting to claim a deduction for federal taxes which they had not actually paid. Yet, it summarily dismissed Mistick's argument that certain identically situated C corporations were being allowed the deduction, with the observation that these cases were distinguishable because C corporations filing "as a group" are subject to federal income tax. (App. A, at p. 17.) This distinction is artificial and without economic significance.[12] It is respectfully submitted

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[12] Although it did not find it necessary to decide the equal protection argument, the Supreme Court of Illinois has found that distinguishing between corporations for tax purposes on the basis that one files federal returns in a consolidated group

that, in basing its rationale for according different treatment to C corporations and S corporations on the premises that (1) one pays taxes and the other does not, and (2) that S corporations are created by voluntary election of its shareholders (thereby ignoring the fact that C corporations may voluntarily elect to file as a consolidated group), the Pennsylvania Supreme Court has given only lip service to enforcing the equal protection clause in this later instance.[13]

CONCLUSION

The decision of the Pennsylvania Supreme Court raises substantial questions under the United States Constitution and has created a critical need for further guidance from this Court. The petition for writ of certiorari should be granted.

Respectfully submitted,

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while the other does not was a violation of the state guarantee of uniformity in taxation. *Searle Pharmaceuticals, Inc. v. Department of Revenue*, 512 N.E.2d 1240 (Ill. 1987).

[13] Nor does this rationale consider that, under certain circumstances, S corporations are also subject to federal tax. 26 U.S.C. § 1374 (built-in gains).

J-157-1993

IN THE SUPREME COURT OF PENNSYLVANIA
MIDDLE DISTRICT

TOOL SALES & SERVICE CO., INC., Appellant	:	Nos. 35 and 36 Middle District Appeal Docket 1993
v.	:	
COMMONWEALTH OF PENNSYLVANIA, BOARD OF FINANCE AND REVENUE, Appellees	:	Appeal from the Order of the Commonwealth Court in the Consolidated Appeals at Docket Numbers 96 F.R. 1989 and 126 F.R. 1989
TOM MISTICK & SONS, INC., Appellant	:	SUBMITTED: August 27, 1993
v.	:	
COMMONWEALTH OF PENNSYLVANIA, BOARD OF FINANCE AND REVENUE, Appellees	:	

OPINION

MR. JUSTICE MONTEMURO

DECIDED: DECEMBER 30, 1993

This is an appeal from a decision of the Commonwealth Court affirming the Board of Finance and Revenue. The Board denied the Appellants, Tool Sales & Service Co., Inc. and Tom Mistick and Sons, Inc., a claimed deduction from their average net income in

determining the value of their capital stock for the purposes of the Pennsylvania Capital Stock Tax.

The issues presented for our review are (1) whether the term "income per books" as set forth in 72 Pa.C.S.A. § 7601(a) must be interpreted to include a deduction for federal income taxes not actually paid by an "S" corporation when calculating the corporation's average net income for the purposes of the Pennsylvania Capital Stock Tax; and (2) whether a Department of Revenue (DOR) regulation that allows "C" corporations to deduct federal taxes when calculating income per books while prohibiting "S" corporations from doing so violates the Equal Protection Clause of the United States Constitution and the guarantee of uniformity of taxes found in the Pennsylvania Constitution.

In accordance with the Pennsylvania Rules of Appellate Procedure[1], the parties prepared and submitted a stipulation of facts ("Stipulation"). Based on this stipulation we find the pertinent facts as follows:

(1) Appellants Tool Sales & Service Company, Inc., and Tom Mistick & Sons, Inc. ("Taxpayers") are corporations incorporated in Pennsylvania and conduct all of their business in Pennsylvania.

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[1] P.R.A.P. 1571(f) provides in its pertinent part: "No record shall be certified to the court by the Board of Finance and Revenue. After the filing of the petition for review the parties shall take appropriate steps to prepare and file a stipulation of such facts as may be agreed to and to identify issues of fact, if any, which remain to be tried."

(2) The Taxpayers elected to be treated as "S" corporations under both federal and Pennsylvania tax law for the 1984 tax year.

(3) In preparing their tax returns for the 1984 tax year, the Taxpayers deducted from their Pennsylvania Capital Stock Tax report an amount equal to the federal taxes they would have paid if they were corporations subject to federal income tax. As "S" corporations, the Taxpayers were not, in fact, subject to any federal income taxes.[2]

(4) Prior to 1984, DOR allowed "S" corporations to deduct from their income per books an amount equal to the federal taxes they would have paid had they been corporations subject to the federal income tax. However, in 1984, DOR issued new regulations prohibiting "S" corporations from making this deduction although DOR allowed "C" corporations to continue making the deduction. This change in regulations by DOR was concurrent with a statutory change in the manner in which corporations were to determine the value of their capital stock for the purposes of the Pennsylvania Capital Stock Tax.[3]

(5) Using this new regulation, DOR disallowed the Taxpayer's claimed deduction, and recalculated their taxes resulting in an increase in their capital stock taxes for the 1984 tax year.

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[2] Under federal tax law "S" corporations are not subject to taxation on their income. Instead, income is distributed to shareholders who report it on their personal returns. *See* 26 U.S.C. § 1361 et seq.

[3] See Act of December 22, 1983, No. 89, 1 (P.L. 360) codified at 72 Pa.C.S.A. §§ 7601-7602.

(6) The Taxpayers appealed the DOR's settlement to the Board of Appeals which sustained the settlement. On appeal to the Board of Finance and Revenue, the decision of the Board of Appeals was affirmed. The Commonwealth Court upheld the decision of the Board of Finance and Revenue. *See Tool Sales and Service Co., Inc. v. Commonwealth,* 149 Pa. Commw. 389, 613 A.2d 143 (1992).

This court has jurisdiction over this matter pursuant to 42 Pa.C.S.A. § 723(b)[4] and P.R.A.P. 1101(a)(2)[5] which grant an appeal to this court as a matter of right. Pursuant to P.R.A.P. 1571, which governs review of determinations of the Board of Finance and Revenue, the Appellants filed timely exceptions to the Commonwealth Court's decision thus preserving the issues for our review. *See* P.R.A.P. 1571(i)[6].

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[4] **§ 723. Appeals from Commonwealth Court**

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(b) Board of Finance and Revenue matters. Any final order of the Commonwealth Court entered in any appeal from a decision of the Board of Finance and Revenue shall be appealable, as of right, under this section.

[5] **RULE 1101. APPEALS AS OF RIGHT FROM THE COMMONWEALTH COURT**

(a) Scope of Rule. This rule applies to any appeal to the Supreme Court from an order of the Commonwealth Court entered in:

***

(2) Any appeal from a decision of the Board of Finance and Revenue.

[6] 1571(i) provides in its pertinent part: "Any party may file exceptions to an initial determination by the trial court under this rule within 30 days after the entry of the order to which exception is taken. Such timely exceptions shall have the effect

Our standard of review in this matter is governed by P.R.A.P. 1571(f). Appeals taken from the Board of Finance and Revenue are *de novo* in nature, with no record being certified by the board. *Ernest Renda Contracting Co., Inc. v. Commonwealth,* 516 Pa. 325, 532 A.2d 416 (1987).

I. Taxpayers' Statutory Argument

A. The Pennsylvania Capital Stock Tax

Under Pennsylvania tax law, domestic corporations pay a tax on the value of their capital stock. *See generally,* 72 Pa.C.S.A. § 7602 (1990). This is a property tax on the assets of the corporation, not an income tax on the corporation. *See Commonwealth v. Philadelphia Market Street Subway-Elevated Railway Co.,* 408 Pa. 357, 184 A.2d 483 (1962). The value of a corporation's capital stock is determined according to a method set by statue [sic]. Prior to 1984, the Pennsylvania Capital Stock Tax was levied on the appraised value of the corporation's capital stock, which was calculated by taking into consideration the following: (i) the average selling price of the stock; (ii) the corporation's earnings; (iii) the dividends declared; and (iv) the stockholder equity. *See* 61 Pa. Code 155.22. The calculation of a corporation's capital stock value was done on a case by case basis considering each of the four elements. *See, e.g., Market Street Subway,* 408 Pa. at 357, 184 A.2d at 485.

. . . of an order granting reconsideration of the determination previously entered by the court. Issues not raised by exceptions are waived and cannot be raised on appeal."

The present controversy concerns only the corporation earnings element of the pre-1983 method. DOR regulations defined corporate earnings to be "book income as reported to the shareholders . . . " 61 Pa. Code 155.22. Book income was defined by regulation to be "Income as reported in line 1 of schedule M-1 of the Federal 1120 form." *Id.* This line on the 1120 form is titled "net income per books". (Stipulation at para.14.) Under this statutory tax scheme, DOR's practice was to allow both "S" and "C" corporations to deduct federal income taxes from "net income per books" whether or not they were actually liable for the taxes.

For fiscal years beginning in 1984, the General Assembly adopted a fixed formula to determine the value of a corporation's capital stock. Under this new formula, capital stock value is determined by a corporation's average net income and its net worth. *See* 72 Pa.C.S.A. § 7601(a) (1990).[7] The statute defines average net income as follows:

> The net income or loss of the entity shall be the amount set forth as income per books on the income tax return filed by the entity with the federal government for such taxable year, or if no such return is made as would have been set forth had such a return been made.
>
> *Id.*

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[7] The statute provides that a corporation's capital stock value is to be calculated as "the product of one-half times the sum of the average net income capitalized at the rate of nine and one-half percent plus seventy-five percent of net worth, from which product shall be subtracted fifty thousand dollars . . . " 72 Pa.C.S.A. § 7601(a) (1990).

Concurrent with this new statutory scheme of calculating capital stock value, DOR adopted a new policy of no longer allowing "S" corporations to deduct hypothetical federal income taxes from income per books. This policy was later formalized as a DCR regulation. *See* 61 Pa. Code 155.26(g)[8].

Taxpayers argue that the term "income per books" as found in 72 Pa.C.S.A. § 7601 should be interpreted as allowing the taxpayers to deduct from their income per books an amount equal to the federal taxes they hypothetically would have had to pay. DOR argues that this interpretation is contrary to their regulation prohibiting such a deduction. We must now turn to the statutory construction of the term "income per books" to resolve this appeal.

B. Statutory Construction.

The Commonwealth Court resolved this issue of statutory interpretation by applying the federal definition of "income per books" to the Pennsylvania statute. *See Tool Sales,* 149 Pa. Commw. at 394, 613 A.2d at 146. The Commonwealth Court did so *sua sponte.* While this court has

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[8] 61 Pa. Code 155.26(g) provides "No adjustment to net income or loss may be made for Federal income tax which would have been paid by a corporation electing S corporation treatment under Section 1361 of the IRC (26 U.S.C.A. § 1361) or for Commonwealth Corporate Net Income Tax which would have been paid by a corporation electing Pennsylvania S corporation treatment under article 3 of the TRC (72 P.S. §§ 7301-7361) or for Commonwealth personal income tax paid by the shareholders of the corporation."

not addressed the incorporation of federal tax principles into Pennsylvania tax law, other courts in this Commonwealth which have considered the matter have concluded that federal principles do not apply to our tax law. *See, e.g., Tyger Resources,* 134 Pa. Commw. at 168, 578 A.2d at 86. Under the facts of the present case, we find it unnecessary to resort to federal tax law to decide the issue at hand. Therefore, we leave the question of the applicability of federal tax principles to Pennsylvania tax law undecided. Instead, we turn to the well established principles of statutory construction adopted by this Commonwealth.

Statutes in this Commonwealth are interpreted according to the Statutory Construction Act found at 1 Pa.C.S.A. §§ 1901-1991 (Supp. 1993). Section 1903 of this act provides that "words and phrases shall be construed according to . . . their common and approved usage." 1 Pa.C.S.A. § 1903 (a) (Supp. 1993). Words that have acquired a "peculiar and appropriate meaning" must be construed according to that peculiar and appropriate meaning. *Id.* Taxpayers argue that the phrase "income. per books" as found in 72 Pa.C.S.A. § 7601 has acquired such a "peculiar and appropriate meaning." Prior to the passage of the statute, they argue, DOR maintained a policy of allowing "S" corporations to deduct from their income per books an amount equal to the federal income tax they would have paid had they been liable for federal income taxes. The term "income per books", the taxpayers urge, acquired the peculiar meaning of allowing this deduction because of DOR's voluntary policy. Therefore, the taxpayers assert, the General Assembly intended

to include the deduction when they used the term "income per books" in the 1983 Tax Reform Code.[9]

We decline to find that the DOR's voluntary policy of allowing the deduction prior to 1983 created a "peculiar and appropriate" meaning for the purposes of the Statutory Construction Act. The taxpayers concede that the DOR's prior practice was voluntary; no statute compelled, the agency to allow the deduction. It has also been stipulated that generally accepted accounting principles do not compel or endorse this deduction. (Stipulation at para. 20.)

Other courts have found a phrase to have a "peculiar or appropriate meaning" for the purposes of statutory construction where the phrase had been defined by the General Assembly in another statute. *See Commonwealth v. Dodge,* 410 Pa. Super. 189, 599 A.2d 668 (1991); *Tyger & Karl Complete Water Systems Co., Inc. v. Commonwealth,* 5 Pa. Commw. 154, ___ A.2d ___ (1972). For example, in Dodge the court found that the term "firearm" had acquired a peculiar meaning for the purposes of one act because it was specifically defined in another related act. *Dodge,* 599 A.2d at 672.

In the instant case, the General Assembly. has not defined the term "income per books" in this or any other act to give it the peculiar meaning that the Taxpayers would find in the phrase. Nor do generally accepted accounting principles give the phrase such a peculiar meaning, as they are silent on the matter. The taxpayers' only support for giving this term a "peculiar meaning"

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[9] Act of December 22, 1983, No. 89, § 1 (P.L. 360).

for the purposes of statutory construction is DOR's voluntary prior practice. Under the facts of this case, we hold this practice insufficient to give the term "income per books" the peculiar meaning the taxpayers would find.

The taxpayers next urge that the term "income per books" is ambiguous, and direct the court to 1 Pa.C.S.A. § 1921 to resolve this ambiguity. Section 1921 states that where a statute is free from ambiguity the letter is not to be disregarded to pursue its spirit. 1 Pa.C.S.A. §1921(a) (Supp. 1993). However, where the words of a statute are not explicit, a court can consider other enumerated matters. *See* 1 Pa.C.S.A. §1921(c) (1)-(8) (Supp. 1993)[10].

This court agrees with the taxpayers and the Commonwealth Court that, in this instance, the term "income per books" as found in 72 Pa.C.S.A. §7601 is ambiguous. The term is undefined in the statute. The only definition for the term is found in regulations addressing the

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[10] **§1921. Legislative Intent Controls**

* * *

(c) When the words of the statute are not explicit, the intention of the General Assembly may be ascertained by considering, among other matters:

(1) The occasion and necessity for the statute.
(2) The circumstances under which it was enacted.
(3) The mischief to be remedied.
(4) The Object to be obtained.
(5) The former law, if any, including other statutes upon the same or similar subjects.
(6) The consequences of a particular interpretation.
(7) The contemporaneous legislative history.
(8) Legislative and administrative interpretations of such statute.

pre-1983 method of calculating the value of capital stock. Here, the term is defined as "income reported in line 1 of schedule M-1 of the Federal 1120 form." 61 Pa. Code 155.22. This definition is unhelpful because for the years involved here there was no such line on the 1120 form filed by "S" corporations. (Stipulation at para. 15.)

As the term "income per books" is ambiguous in this instance, we turn to the Statutory Construction Act to determine the intent of the General Assembly. The Taxpayers urge us to consider 1921(c) (5), which allows the court to consider "former law, if any, including other statutes upon the same or similar subjects." We find this section offers no assistance in construing the meaning of the term "income per books" because there is no former law to consider. The previous statute does not define the term. The previous regulation enforcing that statute is silent on the deduction of hypothetical federal taxes from income per books. The taxpayers argue that the DOR's voluntary practice constitutes "former law" helpful in determining the intent of the General Assembly. However, we find the DOR's voluntary practice to be just that – a voluntary practice which sheds little light on the intent of the General Assembly.

Thus, the cases the taxpayers have cited for the proposition that a statute does not make changes in prior existing law beyond what is expressly declared in their provisions are inapposite. For example, in *Commonwealth v. Miller,* 469 Pa. 24, 364 A.2d 886 (1976), the court held that a criminal statute silent on the issue of merger of conspiracy with the substantive offense did not change the common law rule that conspiracy did not merge with the substantive offense. Here, we are not dealing with a

well established common law rule, or a statute, or a regulation evidencing the intent of the General Assembly in enacting section 7106. Rather, we are concerned with a voluntary policy of an administrative agency which, in the opinion of this court, sheds no light on the intent of the General Assembly.

Taxpayers, in their brief, fail to consider 1921(c) (8) which allows the court to use "Legislative and administrative interpretations of the statute," in discerning the intent of the General Assembly. We hold this section controlling in interpreting the meaning of the phrase "income per books".

It is a well established principle of administrative law that agencies are entitled deference in interpreting the statutes they enforce. *See, e.g., Pennsylvania Human Relations Commission v. Uniontown Area School District,* 455 Pa. 52, 76, 313 A.2d 156, 169 (1973). *Philadelphia Suburban Corp. v. Commonwealth,* 144 Pa. Commw. 410, 601 A.2d 893 (1991), *allocatur granted,* ___ Pa. ___, ___ A.2d ___ (1992). Other courts in this Commonwealth have held that an administrative agency's interpretation should be overturned or disregarded only for cogent reasons or where it is "clearly erroneous". *Philadelphia Suburban,* 144 Pa. Commw. at 420, 601 A.2d at 898; *Commonwealth Liquor Control Board v. Burrell Food Systems,* 97 Commw. 101, 104, 508 A.2d 1308, 1309, *appeal denied* 513 Pa. 636, 520 A.2d 1386 (1986). Where the statutory scheme is as technically complex as the Tax Reform Code, "a reviewing court must be even more chary to substitute discretion for the expertise of the administrative agency." *Philadelphia Suburban,* 144 Pa. Commw. at 420, 601 A.2d at 898 (quoting *Smithkline Beckman Corp. v. Commonwealth,* 85 Pa Commw.

437, 458, 482 A.2d 1344, 1353 (1984), *aff'd per curiam*, 508 Pa. 359, 498 A.2d 374 (1985). The court in *Smithkline* held that "Department of Revenue Regulations interpreting the Tax Reform Code will not be disregarded by this court unless clearly inconsistent with the code," *Smithkline*, 85 Pa. Commw. at 457-58, 482 A.2d at 1354, 1356.

For the purposes of the present situation we adopt these general principles of administrative law as consistently applied by other courts in this Commonwealth to determine the meaning of the phrase "income per books" in 72 Pa.C.S.A. §7601. The taxpayers here have the burden of establishing that DOR's regulations are clearly erroneous. *See* 72 Pa.C.S.A. §7236 (1990)[11]. We hold that the taxpayers have failed to carry their heavy burden of establishing that the DOR regulation prohibiting their claimed deduction does not comport with the law it is designed to enforce.

Sections 7408 and 7603 of the tax code give DOR the power to "adopt [and] promulgate . . . rules and regulations, not inconsistent with" the statutory provisions regarding the capital stock tax. *See* 72 Pa.C.S.A. §7408(a) (1990). Nothing in the regulation at issue here promulgated by DOR is contradictory to the statutory scheme of calculating average net income as set forth in 72 Pa.C.S.A. §7601. The taxpayers have failed to demonstrate that the regulation is "clearly erroneous." Much of the taxpayers

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[11] **§7236 Burden of Proof**
In all cases of petitions for reassessment, review or repeal, the burden of proof shall be upon petitioner or appellant as the case may be.

argument on this point consists of asserting that the regulation differentiating between "S" and "C" corporations is not the most sensible and equitable tax policy. This is insufficient to carry their heavy burden. On this point we will defer to the considerable expertise of the DOR to determine the appropriate tax policy for this Commonwealth within the intent of the General Assembly.

We find the DOR's regulation a reasonable interpretation of the intent of the General Assembly. Concurrent with a major statutory change in the manner in which the value of capital stock was calculated, the DOR reversed its policy of allowing "S" corporations to deduct from income per books an amount equal to the federal taxes they would have paid had they been liable for federal taxes. DOR asserts that the shift from a totality of the circumstances approach of determining capital stock to a fixed formula required this change in policy formalized at 61 Pa. Code 155.22. DOR has consistently applied this policy since the statutory change. (*See* Stipulation at para. 16.) Nothing in this policy is contrary to the statutory scheme of calculating average net income. Furthermore, the General Assembly has had almost a decade to reverse this regulation had it been contrary to the intent of the statute. The failure of the General Assembly to act is evidence that the regulation is not contrary to its intent. For these reasons we defer to DOR's interpretation of the term "income per books."

II. *Taxpayer's Constitutional Arguments*

Taxpayers next argue that this statute and the DOR regulation enforcing it are in violation of the Uniformity Clause of the Pennsylvania Constitution[12], and the Equal Protection Clause of the United States Constitution. We do not agree.

The analysis to be applied in determining the reasonableness of classifications under the Uniformity Clause of the Pennsylvania Constitution and the Equal Protection Clause of the United States Constitution are the same. *Leventhal v. City of Philadelphia,* 518 Pa. 233, 542 A.2d 1328 (1988). A classification for tax purposes is valid when it is based upon some legitimate distinction between the classes that provides a reasonable and just basis for the different treatment. *Id.* "So long as the classification imposed is based upon some standard capable of reasonable comprehension, be that standard based upon availability to produce revenue or some other legitimate distinction, equal protection of the law has been afforded. *Aldine Apartments v. Commonwealth,* 493 Pa. 480, 487, 426 A.2d 1118, 1122 (1981) (quoting *Commonwealth v. Life Assurance Co. of Pennsylvania,* 419 Pa. 370, 378, 214 A.2d 209, 215 (1965)). The burden is on the taxpayer to demonstrate that a classification made for the purposes of taxation is unreasonable. *Leonard v. Thornberg,* 507 Pa. 317, 489 A.2d 1349 (1985).

In the present situation, the taxpayers assert that 72 Pa.C.S.A. §7601 and the regulation enforcing it found at

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[12] Article VIII, §1 of the Pennsylvania Constitution.

61 Pa. Code 155.26(g) violate both the Pennsylvania Constitution and the United States Constitution because they allow "C" corporations to deduct from their income per books an amount equal to their federal tax liability, but prohibit "S" corporations from deducting an amount equal to the federal taxes they would pay if they were liable for federal taxes. In short, the taxpayers argue that allowing "C" corporations this deduction from income per books but denying the deduction to "S" corporations violates the guarantee of uniformity taxes required in the Pennsylvania Constitution and the guarantee of equal protection of the law found in the United States Constitution.

Using the standards set forth above we hold that neither the Pennsylvania Constitution nor the United States Constitution is violated by this method of determining the value of a corporation's capital stock. We find that the distinction between a "C" corporation and an "S" corporation for the purposes of this deduction is a legitimate one. Under both Pennsylvania and federal tax law, "C" corporations are liable for federal income taxes. In a limited number of circumstances, the owners of corporations may voluntarily elect "S" corporation status. *See* 26 U.S.C. §1362; 72 Pa.C.S.A. §7307. The consequence of this election is that the corporation will not pay federal income taxes. Instead, the income will be passed on to the shareholders who will report the income on their personal returns. *See* 26 U.S.C §1361 et seq.; 72 Pa.C.S.A. §§7307-7309 (1990).

In short, the amount a "C" corporation deducts from its income per books under this regulation will be, most often, equal to the amount it actually pays in federal

income taxes.[13] The amount that the taxpayers wish to deduct and which the regulation prohibits is a hypothetical amount that the "S" corporation will not pay because it is not liable for federal taxes. It is rational to this court that when determining the value of capital stock DOR would allow "C" corporations a deduction for taxes they pay, but prohibit "S" corporations a deduction for hypothetical taxes they do not pay. Once again, much of the taxpayer's argument is that this is not the most sensible or equitable method of taxation. However, the taxpayer's burden was to demonstrate that this was not a rational method of taxation. They have failed to carry this burden.

The analysis for finding a violation of Article III, §32 of the Pennsylvania Constitution prohibiting special laws is the same as for the Equal Protection Clause of the United States Constitution and the Uniformity Clause of the Pennsylvania Constitution. *Leventhal v. City of Philadelphia*, 518 Pa. 233, 542 A.2d 1328 (1988). For the reasons discussed *supra* we find no violation of Article III, §32 of the Pennsylvania Constitution.

As we find no deprivation of any right under the United States Constitution, we find no violation of 42

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[13] The Taxpayers and the DOR agree that, in certain circumstances, "C" corporations filing a consolidated return may receive a deduction for federal taxes from income per books even though they do not actually pay federal taxes.(Stipulation at para. 17.) This occurs because of offsetting losses from other members of the consolidated group. *Id.* We agree with DOR that these situations can be distinguished from "S" corporations because "C" corporations filing as part of a consolidated group are subject to federal income taxes while "S" corporations are not.

U.S.C. §1983 and no reason to grant attorneys' fees pursuant to §42 U.S.C. 1988.

For the reasons stated above the opinion of the Commonwealth Court is affirmed.

Mr. Justice Papadakos Concurs in the Result.

Mr. Justice Larsen did not participate in the decision of this case.

JUDGMENT ENTERED:
FEBRUARY 7, 1994

/s/ Shirley Bailey
CHIEF CLERK

IN THE COMMONWEALTH COURT
OF PENNSYLVANIA

TOOL SALES & SERVICE CO., INC., Petitioner	:	
v.	:	
COMMONWEALTH OF PENNSYLVANIA, Respondent	:	NO. 96 F.R. 1989
TOM MISTICK & SONS, INC., Petitioner	:	
v.	:	
COMMONWEALTH OF PENNSYLVANIA, Respondent	:	NO. 126 F.R. 1989 ARGUED: FEBRUARY 4, 1992

BEFORE: HONORABLE MADALINE PALLADINO, Judge
HONORABLE BERNARD L. McGINLEY, Judge
HONORABLE FRANCIS A. BARRY, Senior Judge

OPINION
BY JUDGE McGINLEY FILED: July 22, 1992

Tool Sales and Service Company, Inc. and Tom Mistick and Sons, Inc. (collectively Taxpayers) appeal orders entered by the Board of Finance and Revenue (Board) that disallowed a deduction representing hypothetical federal tax liability in calculation of Taxpayers' capital

stock value for tax purposes in the years 1984 and 1985. We affirm.

The parties have stipulated to the following facts. Taxpayers qualify for S corporation treatment under federal and state tax laws.[1] During the years in question, Taxpayers were S corporations for both state and federal purposes. Although not subject to state or federal income tax because of their S corporation status, Taxpayers are subject to tax on the value of their capital stock.

One of the elements used to calculate a taxpayer's capital stock tax liability is net income per books. For the tax years 1984 and 1985, in the course of calculating capital stock tax liability, Taxpayers deducted federal taxes from the figures used as net income per books. Subsequently, the Department of Revenue (Department) recalculated Taxpayers' capital stock tax liability without taking the deduction for federal taxes into account. Taxpayer Tom Mistick and Sons, Inc.'s liability was increased from $48,144 to $61,040. Taxpayer Tool Sales & Service Company, Inc.'s liability was increased from $8,087 to $11,254. Taxpayers appealed to the Board, which upheld the Department in two orders both dated April 25, 1989.

The fixed formula for determining capital stock value is found in Section 601 of the Tax Reform Code, Act of

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[1] Both the state and the federal government have enacted provisions that allow taxable income for qualifying small corporations, known as S corporations, to be reported and paid on the tax returns of the individual shareholders. See 26 U.S.C. §1361 *et seq.*; also Act of March 4, 1971, P.L. 6, 72 P.S. §§7307-7307.12. Corporations that do not make this election are commonly referred to as C corporations.

December 23, 1983, P.L. 360, 72 P.S. §7601. Prior to 1983, Section 601 provided for calculation of capital stock value based upon an examination of various components of the business, including actual profits or earnings. In these prior years, it was the practice of the Department to allow both C corporations and S corporations to take a deduction for federal tax when computing average net income for capital stock tax purposes.[2] However, in 1983, Section 601 was amended by the General Assembly to provide a fixed formula for determining capital stock value. The fixed formula is dependent on a number of factors, a critical one being average net income. The amended Section 601 defines average net income as follows:

> The sum of the net incomes or loss for each of the current and immediately preceding four years, divided by five. If the entity has not been in existence for a period of five years, the average net income shall be the average net income for the number of years the entity has actually been in existence. . . . *The net income or loss of the entity for any taxable year shall be the amount set forth as income per books on the income tax return filed by the entity with the Federal government for such taxable year, or if no such return is made, as would have been set forth had such a return been made.* . . . (Emphasis added.)

When the amendment was enacted, the Department adopted a policy for the years controlled by the newly amended Section 601. S corporations were no longer entitled to a deduction for federal income tax, as in reality

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[2] The parties agree that this policy is not mandated by the statute.

only C corporations were required to pay the federal tax. In 1987, the Department codified its policy at 61 Pa. Code §155.26(g) as follows:

> No adjustment to net income or loss may be made for Federal income tax which would have been paid by a corporation electing S Corporation treatment under Section 1361 of the IRC (26 U.S.C. A. §1361) or for Commonwealth Corporate Net Income Tax which would have been paid by a corporation electing Pennsylvania S corporation treatment under article 3 of the IRC (72 P.S. §§7301-7361), or for Commonwealth personal income tax paid by the shareholders of the corporation.

The Department's regulation did not become effective until January 17, 1987, subsequent to the tax years at issue. However, the Department states, and Taxpayers do not contest, that the regulation is an enactment of the Department's previously established interpretation of Section 601, and that since the enactment of Section 601, which became effective for tax years beginning on or after January 1, 1984, the Department has uniformly not allowed the deduction of hypothetical income taxes by S corporations in the calculation of net income per books.

First, Taxpayers contend that the Department's refusal to allow an S corporation the same deductions for federal income tax allowed C corporations, who actually pay the tax, contradicts the express terms of Section 601, usurps legislative authority, and amounts to unauthorized legislation. Secondly, Taxpayers allege that the Department's regulation results in a different tax base for taxpayers who are similarly situated, which, they

argue, is a violation of Article 8, Section 1 of the Pennsylvania Constitution, the Equal Protection Clause of the United States Constitution, and Article 3, Section 32 of the Pennsylvania Constitution (prohibiting special laws), and Section 1983 of the Civil Rights Act, 42 U.S.C. §1983. Taxpayers concede that except for the disallowance of the deduction for federal income tax, the Department's calculation of their net income is correct.

When interpreting a statute, this Court must ascertain and effectuate the intent of the General Assembly, and our legislators are presumed not to have intended a result that is absurd or unreasonable. *Doyle Equipment Company v. Commonwealth*, 117 Pa. Commonwealth Ct. 38, 542 A.2d 64 (1988). Any resolution of the issue before us hinges on an interpretation of the phrase "income per books" in Section 601's definition of "average net income." A problem arises in ascertaining legislative intent with regard to the "income per books" of an S corporation. Although an entity's average net income is defined with reference to a particular section of the entity's federal tax return, and S corporations are defined as entities for the purposes of Section 601, the federal tax form for an S corporation for the years in question did not include a line entry titled "income per books." Consequently, the federal tax returns filed by the Taxpayers for the pertinent years do not include a line entry for "income per books."

Federal Tax Form 1120, which is the C corporation income tax return, contains Schedule M-1, a section designed for reconciliation of income per books with income per return. Line 1 of Schedule M-1 is reserved for the C corporation's calculation of "Net income per

books." In 1984 and 1985, the S corporation return did not contain such a line.[3] Since "income per books" is not reported on the S corporation's federal tax return for the years 1984 and 1985, Taxpayers' propose that it be determined hypothetically, based upon what an S corporation would have reported as income per books, just like a C corporation: in other words, as if it had to pay taxes. Taxpayers argue that the Department's regulation equates "net income per books" with the amount listed as ordinary income on the S Corporation's tax return, which, they claim, is an arbitrary decision not supported by the statute.

The Department contends that its regulation does not contradict the terms of the statute. The Department also states that any deduction of a hypothetical federal income tax when calculating net income is unauthorized by any generally accepted accounting principles. This characterization of the issue overlooks the obvious question raised by Taxpayers, which is, what did the General Assembly intend when it defined net income as "the amount set forth as income per books on the income tax return filed by the entity with the Federal government"?

The words of this statute are not precise because they actually do not refer to a clearly discernable and reported figure on the income tax return of all entities subject to the capital stock franchise tax. When confronted by such

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[3] Schedule M-1 first appeared on the S corporation return, Form 1120S, in 1990. The Department recognizes that "income per books," which is the term appearing in the statute, refers to "net income per books."

legislation, the intention of the legislature must be ascertained by considering, among other matters, the object to be attained. 1 Pa.C.S. §1921(c). Here it is apparent that the General Assembly intended entities subject to the capital stock franchise tax to determine income according to what the federal law recognized as net income per books.

Internal Revenue Regulation (IRR) 1.56-1, 26 C.F.R. 1.56-1 (1991), deals with adjustments for the book income of corporations.[4] IRR 1.56-1(b)(2)(i) defines net book income as the income or loss for a taxpayer reported in the taxpayer's applicable financial statement. IRR 1.56-1(c)(1) provides that the applicable financial statement of a corporation is a statement required to be filed with the Securities and Exchange Commission, a certified audit statement used for a substantial non-tax purpose, a financial statement provided to a government regulator or a financial statement that is not a certified audit but is used for a substantial non-tax purpose. If a corporation does not have a financial statement available for the year that satisfies one of the previous definitions, the net book income is considered equivalent to current earnings and profits. IRR 1-56.1(c)(1)(vi), 26 C.F.R. 1-56.1(c)(1)(vi). If the only financial statement that a corporation has for the year in question is a financial statement that is not a certified audit but is used for a substantial non-tax purpose, the corporation may elect to treat net book income

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[4] We note that by its terms, IRR 1.56-1 does not apply to S corporations, which were not reporting reconciliations of net income per books with taxable income to the Internal Revenue Service on August 17, 1990, when the regulation went into effect.

as equal to current earnings and profits. IRR 1-56.1(c)(1)(v), 26 C.F.R. 1-56.1(c)(1)(v).

From this examination of the federal approach to determining net income per books, we conclude that the intention of the General Assembly when enacting the definition of average net income in Section 601 was to direct the use of a figure for income that is set forth in the corporation's financial statements that are not used for tax purposes. Although Taxpayers attack the Department's policy and the regulation codifying that policy, they do not claim that the Department's estimation of their average net income deviates from the calculations of income expressed in their own financial records. Just as there is no specific denial of a hypothetical federal income tax deduction for S corporations in Section 601, there is no specific legislative authorization for one. The policy change effected by the Department was concurrent with the legislative amendments to the tax laws regarding the calculation of capital. stock value and the corporate net income laws regarding the taxation of S corporations. We believe that Taxpayers have not carried their burden of showing that the Department's regulation does not comport with the law it is designed to enforce.

Taxpayers' claim of unequal treatment under the law is likewise unconvincing, as is their claim for attorney's fees under 42 U.S.C. §1983. Taxpayers allege that the Department is treating similarly situated taxpayers differently, but the truth is that S corporations and C corporations are not similarly situated. When a corporation elects to be an S corporation, it does so freely, and knowingly chooses to distinguish itself from a C corporation. By

such election the S corporation enjoys the financial benefit of avoiding federal tax liability. The Department's regulation simply reflects this very real difference.

Taxpayers' claim that the Department's action is in violation of Article 3, Section 32 of the Pennsylvania Constitution. Article 3, Section 32 prohibits the General Assembly from passing a local or special law in any case that has been or can be provided for by general law, and specifically prohibits the General Assembly from making local or special laws exempting certain property from taxation, along with other specific prohibitions. Section 601, as passed by the General Assembly, applies equally and across the board to C and S corporations, partnerships and various other entities. Taxpayers' allegation that this is a special law is rejected.

The decision of the Board is affirmed.

/s/ B. L. McGinley
BERNARD L. McGINLEY,
Judge

IN THE COMMONWEALTH COURT
OF PENNSYLVANIA

TOOL SALES & SERVICE CO., INC., Petitioner	:	
v.	:	
COMMONWEALTH OF PENNSYLVANIA, Respondent	:	NO. 96 F.R. 1989
TOM MISTICK & SONS, INC., Petitioner	:	
v.	:	
COMMONWEALTH OF PENNSYLVANIA, Respondent	:	NO. 126 F.R. 1989

ORDER

AND NOW, this 22nd day of July, 1992, unless exceptions are filed within thirty (30) days of the date hereof, the Chief Clerk is directed to enter judgment in favor of the Commonwealth and against Petitioner Tool Sales and Service Co., Inc., in the amount of $3,167, and in favor of the Commonwealth and against Petitioner Tom Mistick & Sons, Inc., in the amount of $12,896.

/s/ B. L. McGinley
BERNARD L. McGINLEY,
Judge

J-157-1993

IN THE SUPREME COURT OF PENNSYLVANIA
MIDDLE DISTRICT

TOM MISTICK AND SONS, INC.,	:	No. 36 Middle District Appeal Docket 1993
Appellant	:	
v.	:	
COMMONWEALTH OF PENNSYLVANIA, BOARD OF FINANCE AND REVENUE,	:	Application for Reargument
Appellee	:	

ORDER

PER CURIAM:

AND NOW, this 21st day of March, 1994, the Application for Reargument is DENIED.

Mr. Justice Frank J. Montemuro is sitting by designation as Senior Justice pursuant to Judicial Assignment Docket No. 94 R1800, due to the unavailability of Mr. Justice Rolf Larsen, see No. 127 Judicial Administration Docket No. 1, filed October 28, 1993.

TRUE AND CORRECT COPY:
Attest: March 22, 1994

/s/ Shirley Bailey
CHIEF CLERK
MIDDLE DISTRICT

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

TOOL SALES & SERVICE CO., INC.,	:	
Petitioner	:	
v.	:	
COMMONWEALTH OF PENNSYLVANIA,	:	NO. 96 F.R. 1989
Respondent	:	
TOM MISTICK & SONS, INC.,	:	
Petitioner	:	NO. 126 F.R. 1989
v.	:	ARGUED: MARCH 3, 1993
COMMONWEALTH OF PENNSYLVANIA,	:	
Respondent	:	

ORDER

AND NOW, this 5th day of March, 1993, after consideration of argument, Petitioners' exceptions to our order of July 22, 1992, are hereby dismissed.

/s/ Bernard L. McGinley
BERNARD L. McGINLEY,
Judge

CONSTITUTIONAL STATUTORY AND REGULATORY PROVISIONS INVOLVED

Amendment XIV, Section 1

. . . No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

42 U.S.C.A. § 1983-Civil Action for Deprivation of Rights

Every person who, under color of any statute, ordinance, regulation, custom or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C.A. § 1988-Proceedings in Vindication of Civil Rights; Attorney's Fees

. . . In any action or proceeding to enforce a provision of section 1981, 1982, 1983, 1985, and 1986 of this title, title IX of Public Law 92-318, or title VI of the Civil Rights Act of 1964, the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs.

72 Pa.C.S.A. § 7601(a)-Capital Stock Value

The amount computed pursuant to the following formula: the product of one-half times the sum of the average net income capitalized at the rate of nine and one-half percent plus seventy-five percent of net worth, from which product shall be subtracted fifty thousand dollars ($50,000). . . .

72 Pa.C.S.A. § 7601(a)-Average Net Income

. . . The net income or loss of the entity for any taxable year shall be the amount set forth as income per books on the income tax return filed by the entity with the Federal government for such taxable year, or if no such return is made, as would have been set forth had such a return been made. . . .

61 Pa. Code § 155.26(g)-Average Net Income – Fixed Formula

(g) No adjustment to net income or loss may be made for Federal income tax which would have been paid by a corporation electing S Corporation treatment under Section 1361 of the IRC (26 U.S.C.A. § 1361) or for Commonwealth Corporate Net Income Tax which would have been paid by a corporation electing Pennsylvania S corporation treatment under article 3 of the TRC (72 P.S. §§ 7301-7361), or for Commonwealth personal income tax paid by the shareholders of the corporation.

Supreme Court, U.S.
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No. 93-2031

IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1993

TOM MISTICK & SONS, INC.,

Petitioner

v.

COMMONWEALTH OF PENNSYLVANIA,

Respondent

Petition For A Writ Of Certiorari
To the Supreme Court of Pennsylvania

BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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COUNTERSTATEMENT OF THE QUESTION PRESENTED

Does Pennsylvania's refusal to allow federal S corporations a state tax deduction for hypothetical federal income taxes which they do not pay and are not subject to represent a violation of the Equal Protection Clause?

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STATUTES

Sections 1361-1366 of the Internal Revenue Code,

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COUNTERSTATEMENT OF THE CASE

Petitioner, Tom Mistick & Sons, Inc., elected federal S corporation status with the Internal Revenue Service and this election was effective for the tax years in issue. (R. p. 48a). As an S corporation, Petitioner is not subject to and does not pay federal income tax. Instead the shareholders report their proportionate share of the S corporations' taxable income on their individual federal income tax returns. 26 U.S.C. §1361, et seq. This income is then treated as the personal income of the shareholder.

Corporations which do not or cannot elect S corporation status are taxed under Subchapter C of the Internal Revenue Code, 26 U.S.C. 301, et seq., and are referred to as C corporations. C Corporations are subject to and do pay federal income tax when this liability arises.

Both S and C corporations are subject to a Pennsylvania tax on their value, known as the capital stock tax. Value for capital stock tax purposes is computed under a statutory formula which considers the net income of the corporation. C corporations deduct federal income taxes paid in arriving at net income, but S corporations, which are not subject to and do not pay federal income taxes, are denied such a deduction by Pennsylvania tax regulations.

Petitioner now challenges the constitutional validity of the Pennsylvania rule which does not allow S corporations a deduction for a tax they did not pay. While both C and S corporations are subject to capital stock tax at the same tax rate, the difference

in treatment for calculating net income reflects the very real economic difference between the two types of entities. (R.p. 52a.)

SUMMARY OF ARGUMENT

A rule prohibiting a deduction with respect to a tax to which the taxpayer is not subject and does not pay is facially rational. By wholly voluntary elections, corporations choosing S corporation status avoid the federal income tax. The Pennsylvania rule disallowing a deduction for the hypothetical tax such corporations would have paid in the absence of the election does not violate the Equal Protection Clause. No substantial federal question has been raised in the petition for writ of certiorari and said petition should be denied.

ARGUMENT

I. PENNSYLVANIA'S CAPITAL STOCK TAX PROVISIONS AND THEIR APPLICATION TO S CORPORATIONS

This Petition involves the constitutional validity of the valuation provisions of the Pennsylvania capital stock tax, specifically its application to S corporations under Federal income tax law. The Pennsylvania capital stock tax is a tax on the value of a corporation, calculated in accordance with the statutory formula. Pa. Stat. An. Title 72, §7601(a)(Purdon 1990). This formula relies on both net worth and net income (or average net income) in determining the corporation's value. The net worth aspect of the computation is not at issue; the net income component, specifically its application to S corporations, is the issue in this case.

An S corporation is defined by Section 1361 of the Internal Revenue Code, 26 U.S.C. §1361. In order to qualify as an S corporation, the corporation cannot have more than 35 shareholders, may not have another corporation as a shareholder, and may not have more than one class of stock. 26 U.S.C. §1361(b). Most important, a corporation must affirmatively elect S corporation status with the Internal Revenue Service, and all shareholders must consent to this election. 26 U.S.C. §1362(a). The general rule is that S corporations are not subject to and do not pay federal income tax. 26 U.S.C. §1363(a). Instead, the shareholders report their proportionate share of the S corporation's income as taxable income on their individual federal income tax returns. 26 U.S.C. §1366. A corporation may

prospectively elect out of S corporation status if the shareholders holding more than one-half of the shares of the stock of the corporation consent to the revocation of the S corporation election 26 U.S.C. §1362(d).

For purposes of Pennsylvania's capital stock tax, the definition of net income per books is contained in the definition of "average net income" which is found in Section 601(a) of the Tax Reform Code, Pa. Stat. An., Title 72, §7601(a). Pursuant to its authority, the Pennsylvania Department of Revenue has promulgated a regulation, 61 Pa. Code §155.26, interpreting the statutory definition of average net income for purposes of calculating the value of a corporation's stock. This regulation contains the following provision which is central to this appeal:

> No adjustment to net income or loss may be made for Federal income tax which would have been paid by a corporation electing S corporation treatment under Section 1361 of the IRC (26 U.S.C.A. §1361) or for Commonwealth Corporate Net Income Tax which would have been paid by a corporation electing Pennsylvania S corporation treatment under Article III of the T.R.C. (72 P.S. §7301-7361) or for Commonwealth personal income tax paid by the shareholders of the corporation.

61 Pa. Code §155.26(g).

As a matter of Pennsylvania law, the Pennsylvania Supreme Court has decided that this regulation is a proper interpretation of the statutory definition of net income for capital stock valuation purposes. Tool Sales & Service Co., Inc., v. Commonwealth, _____ Pa. _____, 637 A.2d

607 (1993). Consequently, under Pennsylvania law, S corporations subject to the capital stock tax cannot deduct the federal income tax they would have paid or would be liable for if they had not chosen to operate as S corporations under Federal income tax law.

II. PENNSYLVANIA'S TREATMENT OF S CORPORATIONS IS CONSTITUTIONAL

Pennsylvania's rule prohibiting S corporations from deducting a hypothetical income tax (to which they are not subject and which they do not pay) in arriving at their net income for capital stock valuation purposes is rational and reasonable, and does not violate the Equal Protection Clause of the United States Constitution.

Petitioner voluntarily elected S corporation status. It now claims that

the Equal Protection Clause guarantees it the right to claim a hypothetical deduction without actually incurring the corresponding tax liability.[1] Clearly, a rule which does not permit the deduction of a hypothetical tax is a rational law.

This Court set forth the standard for equal protection challenges to tax laws in Nordlinger v. Hahn, 505 U.S. _____, 120 L.Ed 2d 1, 13, 112 S.Ct. 2326, _____ (1992).

> In general, the Equal Protection Clause is satisfied so long as there is a plausible policy reason for the classification, the legislative facts on which the classifi-

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[1]It is undisputed that the shareholders of the S corporation must report the earnings of the corporation on their individual federal tax returns and pay tax thereon. This is not relevant, however, because the Pennsylvania law in question governs the valuation of the corporate entity, not the valuation of any of the shareholders.

> cation is apparently based rationally may have been considered to be true by the governmental decision maker, and the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational. This standard is especially deferential in the context of classifications made by complex tax laws. "[I]n structuring internal taxation schemes, `the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." (Citations omitted)

The Pennsylvania regulation sets forth a rule which distinguishes between corporations which are subject to the federal income tax and corporations which are not subject to the federal income tax. This represents a reasonable determination

that corporate entities which are not subject to and do not pay federal income tax have, all other things being equal, a higher value than corporations which are subject to and do pay the federal income tax. S corporations and C corporations are not similarly situated and the Pennsylvania law rationally reflects this distinction.

Petitioner challenges a law that rationally distinguishes between different classes of corporate taxpayers, those which elect S corporation treatment and corporations which are C corporations. "The Equal Protection Clause `applies only to taxation which in fact bears unequally on persons or property of the same class'". Allegheny Pittsburgh Coal Company v. County Commissioner of Webster County, 488 U.S. 336, 343, 102 L.Ed 2d 688, 1095 Ct. 633 (1989), citing

Charleston Fed. Savings & Loan Assn. v. Alderson, 324 U.S. 182, 190, 89 L.Ed. 2d 857, 65 S. Ct. 624 (1945). S corporations and C corporations are unequivocally different in their treatment under the Federal income tax laws and this treatment affects their economic value. Pennsylvania's law which incorporates this difference is based on a "plausible policy reason".

CONCLUSION

For the reasons stated, the Commonwealth of Pennsylvania respectfully submits that the petition for writ of certiorari presents no substantial federal question, and that the distinction drawn by the challenged Pennsylvania law is reasonable, rational and well within the confines of the Equal Protection Clause. On these grounds, the petition for writ of certiorari should be denied.

Respectfully submitted,

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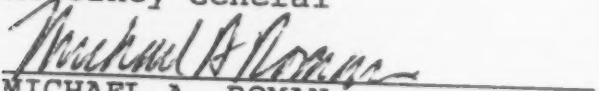
By: 

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